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THE BONDS OF JOINT TAX LIABILITY SHOULD NOT BE STRONGER THAN MARRIAGE: CONGRESSIONAL INTENT BEHIND § 6015(c) SEPARATION OF LIABILITY RELIEF

Svetlana G. Attestatova

Abstract: Spouses who file joint tax returns are jointly and severally liable for any resulting tax deficiency. In the past, only innocent spouses—those with no knowledge of the tax understatement—could qualify for relief from such liability. In 1998, Congress expanded existing innocent spouse relief and added two new forms of relief—the separation of liability and discretionary relief provisions. Codified at 26 U.S.C. § 6015(c), separation of liability relief allocates items that give rise to a deficiency to each spouse as if they had filed separate returns, and is only available to spouses who are divorced, separated, or living apart. However, a claimant spouse cannot obtain separation of liability relief if the Secretary of the Treasury can prove the claimant had actual knowledge of “any item giving rise to a deficiency.” Courts and the Department of the Treasury have interpreted this exception to refer to the transaction underlying a deficiency. In contrast, taxpayers and members of the Tax Section of the American Bar Association argue that this statutory language means an item on a joint return. This Comment examines the text, structure, and legislative history of § 6015(c), and concludes that there is strong support for the latter reading. Therefore, this Comment urges Congress and the Treasury to amend § 6015(c) and its implementing regulations to clarify Congress’ intended meaning.

Filing a joint tax return generally subjects spouses to joint and several liability.¹ Until 1971, this rule was absolute and resulted in cases of “grave injustice.”² The typical case of inequity arose when one spouse failed to report embezzled funds on a joint return, secretly squandered them, and then deserted the other spouse.³ Often the other spouse had derived no benefit from the funds and had no knowledge of the embezzler’s activities or the resulting omission on the tax return, but was nevertheless held jointly and severally liable for the resulting tax

1. 26 U.S.C. § 6013(d)(3) (2000); see also Richard C.E. Beck, *The Innocent Spouse Problem: Joint and Several Liability for Income Taxes Should Be Repealed*, 43 VAND. L. REV. 317, 319 n.2 (1990) (“This rule has been in the statute since 1938, but before that date it was controversial and the subject of litigation.”). Joint and several liability is “[l]iability that may be apportioned either among two or more parties or to only one or a few select members of the group, at the adversary’s discretion.” BLACK’S LAW DICTIONARY 926 (7th ed. 1999).

2. See S. REP. NO. 91-1537, at 2 (1970) (citing Louise M. Scudder, 48 T.C. 36, 41 (1967) (recognizing the inflexibility and harshness of the statute when a wife was held liable for tax liability created by her husband’s failure to report embezzled funds)).

3. See *id.*

deficiency.⁴ In 1971, Congress recognized the injustice of holding such a spouse liable, and lessened the harshness of the joint and several liability rule.⁵ Congress enacted a relief provision⁶ that became known as *innocent spouse relief*,⁷ which alleviated liability for spouses who had no knowledge of and did not significantly benefit from the omitted income.⁸ This provision, codified at 26 U.S.C. § 6013(e), was intended “to bring government tax collection practices into accord with basic principles of equity and fairness.”⁹ Since the enactment of § 6013(e) in 1971, the scope of joint and several liability relief has been expanded twice—first in 1984,¹⁰ and again in 1998.¹¹

While inequity is apparent in the case of the embezzler spouse, it is not as clear in a case where one spouse receives retirement distributions, erroneously claims them as non-taxable on a joint return, and uses the funds to pay off the mortgage on the family home.¹² If the spouses later divorce, the second spouse, who did not receive the retirement funds but knew about their receipt by the first spouse, may be awarded the family home pursuant to a divorce decree.¹³ Should that second spouse, who significantly benefited from the retirement funds, nonetheless be relieved from joint and several liability for the deficiency caused by the funds’ omission from the joint return? Under § 6013(e), the second spouse remained liable because he or she knew or had reason to know of

4. *Id.*

5. *See id.*; H.R. REP. NO. 91-1734, at 2 (1970).

6. *See* Act of Jan. 12, 1971, Pub. L. No. 91-679, § 1, 84 Stat. 2063, 2063 (codified at 26 U.S.C. § 6013(e) (1982) (current version at 26 U.S.C. § 6015 (2000))).

7. Although former § 6013(e) did not actually use that term, the courts did. *See* Ewing v. Comm’r, 118 T.C. 494, 518 n.3 (2002) (Laro, J., dissenting) (noting that the term *innocent spouse* was apparently spawned in *Spanos v. United States*, 212 F. Supp. 861, 864 (D. Md. 1963), where the court described a taxpayer who had filed a joint return with her husband as an *innocent spouse* after noting that the taxpayer had no income of her own and was innocent of her husband’s fraudulent failure to file a federal income tax return when it was due).

8. *See* 26 U.S.C. § 6013(e)(1) (1982) (current version at 26 U.S.C. § 6015 (2000)).

9. S. REP. NO. 91-1537, at 2; H.R. REP. NO. 91-1734, at 2.

10. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 424, 98 Stat. 494, 801–03 (codified at 26 U.S.C. § 6013(e) (1994) (current version at 26 U.S.C. § 6015 (2000))).

11. *See* Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3201(a), (e)(1), 112 Stat. 734, 734–39 (codified at 26 U.S.C. § 6015 (2000)).

12. Hypothetical based on *Cheshire v. Commissioner*, 282 F.3d 326 (5th Cir. 2002).

13. *See id.* at 330.

the tax understatement, which has been interpreted by courts to mean knowledge of the underlying transaction.¹⁴

Congress enacted extensive changes to § 6013(e) in 1998, replacing it with § 6015.¹⁵ Section 6015 provides three different forms of relief: *innocent spouse* relief under § 6015(b), *separation of liability* relief under § 6015(c), and *discretionary* relief under § 6015(f).¹⁶ Separation of liability relief is only available to spouses who are divorced, separated, or living apart.¹⁷ However, that form of relief is not available if a claimant spouse has actual knowledge of the “item giving rise to a deficiency” on a joint tax return.¹⁸ The language *item giving rise to a deficiency* can have two meanings: (1) the spouse knows about the underlying transaction that gave rise to the omitted income (or the erroneously claimed deduction or credit, as the case may be), or (2) the spouse knows that the item on the return was incorrect when it was signed.¹⁹ Under the *underlying transaction* interpretation, separation of liability relief would not be available to the second spouse in the example above because that spouse had actual knowledge of the retirement funds.²⁰ However, under the *item on a return* interpretation, the second spouse could obtain separation of liability relief despite knowing about the retirement funds, as long as the spouse did not know that the funds’ tax treatment on a return was incorrect.²¹

14. *Cf. id.* at 332–35 (applying requirements similar to the pre-1998 provision to a post-1998-amendment case).

15. *See infra* Part I.A.

16. *See* 26 U.S.C. § 6015 (2000).

17. *Id.* § 6015(c)(3)(A).

18. *Id.* § 6015(c)(3)(C).

19. *See* *Cheshire v. Comm’r*, 115 T.C. 183, 203 (2000) (Colvin, J., dissenting).

20. *See* *Mitchell v. Comm’r*, 292 F.3d 800, 805 (D.C. Cir. 2002); *Cheshire v. Comm’r*, 282 F.3d 326, 335 (5th Cir. 2002). This Comment will use the term *underlying transaction* to encompass a variety of phrases used by courts. *See Mitchell*, 292 F.3d at 806 (holding that the Service does not have to show “actual knowledge of the improper tax treatment of an item”); *Cheshire*, 282 F.3d at 337 (using the phrase “an item of income, deduction or credit”); *Cheshire*, 115 T.C. at 195 (using the phrase “an actual and clear awareness of the omitted income” in cases of omitted income). *But cf. Cheshire*, 115 T.C. at 200 (Thornton, J., concurring) (concluding that the majority’s standard requiring knowledge of omitted income “inherently rejects” the Internal Revenue Service’s argument that “actual knowledge of an ‘item’ means actual knowledge merely of the event or transaction giving rise to the deficiency”).

21. *See Cheshire*, 115 T.C. at 203–07 (Colvin, J., dissenting). This Comment will use the term *item on a return* to cover a variety of phrases used to describe knowledge of incorrect tax reporting. *See, e.g., Cheshire*, 282 F.3d at 335–36 (rejecting taxpayer’s argument that knowledge refers to “incorrect tax reporting of an item of income, deduction or credit” and refusing to construe the statute to bar relief only for spouses who know that “an entry on the joint tax return is incorrect”);

This Comment argues that Congress intended separation of liability relief to apply to spouses who did not have actual knowledge that a particular item on a joint return was incorrectly claimed, even if they did have knowledge of the underlying transaction giving rise to that item. Part I describes the legislative history of § 6015, and its three types of relief, focusing on the operation of the separation of liability relief provision. Part II examines how the actual knowledge exception to separation of liability relief has been interpreted. Part III looks at the case law interpreting the knowledge requirement of innocent spouse relief under § 6015(b) and former § 6013(e). Finally, Part IV analyzes the text, structure, and legislative history of the actual knowledge exception, and argues that spouses who do not have actual knowledge of an incorrect item on a joint return, but who know about the underlying transaction, should still be allowed to separate their tax liability. This Comment further suggests that the overbroad judicial interpretation of the actual knowledge exception should be remedied by a legislative or administrative amendment.

I. SECTION 6015 PROVIDES SPOUSES WITH THREE AVENUES OF RELIEF FROM JOINT AND SEVERAL LIABILITY

When Congress broadened joint and several liability relief in 1998, it was responding to the inadequacy of taxpayer protection under the pre-1998 innocent spouse provision.²² With that remedial purpose in mind, Congress added two new forms of relief and expanded the existing innocent spouse relief.²³ One of the new forms of relief is the separation of liability provision, which is premised on the principle of individual responsibility and is granted only to spouses who are divorced, separated, or living apart.²⁴ The second new form of relief is the discretionary relief provision, which permits the Secretary of the Treasury (the Secretary) to extend relief in cases where a taxpayer

Cheshire, 115 T.C. at 206–07 (Colvin, J., dissenting) (concluding that the knowledge requirement means “knowledge that the return is incorrect, not knowledge that there was an income-producing activity or transaction”).

22. See H.R. CONF. REP. NO. 105-599, at 249–52 (1998).

23. See *id.*

24. See 26 U.S.C. § 6015(c) (2000); see also *infra* text accompanying notes 53–62, 79–101.

cannot qualify for either innocent spouse or separation of liability relief, but still merits protection.²⁵

A. Congress Enacted § 6015 to Remedy the Inadequate Protection of Spouses Under Former § 6013(e)

Congress first expanded the original innocent spouse relief provision in 1984.²⁶ This amendment to § 6013(e) extended relief not only to cases of income omitted from a return,²⁷ but also to cases involving an erroneously claimed deduction, credit, or basis.²⁸ To obtain relief under the 1984 amendment, the claimant spouse had to prove five elements: (1) a joint return had been filed; (2) the tax understatement was “substantial” (over \$500 and a specified percentage of a spouse’s income); (3) this understatement was attributable to “grossly erroneous” items (either omitted from gross income or having no basis in fact or law in case of a deduction, credit, or basis); (4) the claimant had no actual or constructive knowledge of such understatement; and (5) it would be inequitable to hold the claimant liable for the tax deficiency.²⁹

Despite this expansion, § 6013(e) proved inadequate because its many stringent requirements were extremely difficult for a claimant spouse to prove.³⁰ Out of the five statutory relief requirements under former § 6013(e),³¹ the only requirement that was easily satisfied was showing that a joint return had been filed. The substantial understatement requirement³² caused hardships to some taxpayers if their liability was \$500 or less.³³ In addition, courts differed widely in their interpretations

25. See 26 U.S.C. § 6015(f); see also *infra* text accompanying notes 74–78.

26. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 424, 98 Stat. 494, 801–03 (codified at 26 U.S.C. § 6013(e) (1994) (current version at 26 U.S.C. § 6015 (2000))).

27. See 26 U.S.C. § 6013(e)(1)(A) (1982) (current version at 26 U.S.C. § 6015 (2000)).

28. See 26 U.S.C. § 6013(e)(2) (1994) (current version at 26 U.S.C. § 6015 (2000)).

29. See *id.* § 6013(e)(1)–(4).

30. Senator Graham remarked that pre-1998 innocent spouse relief was merely “theoretical” because it was “virtually impossible for the standards of that innocent spouse provision to be met.” 144 CONG. REC. S4473–74 (daily ed. May 7, 1998). See also Jessica L. Angney, Note, *It’s New but Is It Improved?: The New “Innocent Spouse” Provision*, 47 CLEV. ST. L. REV. 603, 605–10 (1999).

31. See 26 U.S.C. § 6013(e)(1)–(4) (1994) (current version at 26 U.S.C. § 6015 (2000)).

32. *Id.* § 6013(e)(1)(B), (e)(3); see also *supra* text accompanying note 29.

33. See DEP’T OF THE TREASURY, REPORT TO THE CONGRESS ON JOINT LIABILITY AND INNOCENT SPOUSE ISSUES 49–50 (1998) [hereinafter 1998 TREASURY REPORT], available at <http://www.ustreas.gov/press/releases/reports/innospos.pdf>.

of what deductions met the standard of “having no basis in fact or law,”³⁴ under the “grossly erroneous” requirement.³⁵ The requirement that a claimant spouse must have no actual or constructive knowledge of the tax understatement³⁶—the “innocence” requirement³⁷—resulted in a large body of conflicting case law with unpredictable outcomes.³⁸ Commentators harshly criticized this innocence requirement for having “degenerated into a subjective [inquiry] best characterized as whether the spouse seeking relief can move the judge to sympathy.”³⁹ Similarly, the requirement that holding a claimant spouse liable for a tax deficiency must be inequitable⁴⁰—the “equity” requirement⁴¹—was criticized for being “vague and unpredictable.”⁴²

Proposals to modify § 6013(e) ranged from urging the complete repeal of joint and several liability to abolishing the filing of joint returns.⁴³ In 1998, Congress replaced § 6013(e) with § 6015 as part of the Internal Revenue Service Restructuring and Reform Act of 1998.⁴⁴ Congress was concerned with the inadequacy of the innocent spouse provisions⁴⁵ and enacted § 6015 to make relief from joint and several liability more accessible.⁴⁶ Like former § 6013(e),⁴⁷ § 6015 had a broad remedial purpose.⁴⁸

34. JOINT COMM. ON TAXATION, 105TH CONG., 2D SESS., PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF ‘INNOCENT SPOUSES,’ JCX-6-98, at 6 nn.29–31 (J. Comm. Print 1998) [hereinafter 1998 BACKGROUND REPORT], available at <http://www.house.gov/jct/x-6-98.htm>.

35. See 26 U.S.C. § 6013(e)(1)(B), (e)(2) (1994) (current version at 26 U.S.C. § 6015 (2000)); see also *supra* text accompanying note 29.

36. See 26 U.S.C. § 6013(e)(1)(C); see also *supra* text accompanying note 29.

37. Beck, *supra* note 1, at 326, 351–52; American Bar Association Resolutions and Report adopted by its House of Delegates in Feb. 1995, filed as Addendum to Brief of Amici Curiae in Favor of Reversal, at 5, *Cheshire v. Comm’r*, 282 F.3d 326 (5th Cir. 2002) (No. 00-60855) [hereinafter ABA Proposal].

38. *Exploring the Development of Taxpayer Bill of Rights II Legislation: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 104th Cong. 104–05 (1995) (statement of Richard C.E. Beck, professor of law) [hereinafter *Statement of Professor Beck*].

39. ABA Proposal, *supra* note 37, at 5; see *Statement of Professor Beck*, *supra* note 38, at 106.

40. See 26 U.S.C. § 6013(e)(1)(D) (1994) (current version at 26 U.S.C. § 6015 (2000)); see also *supra* text accompanying note 29.

41. *Statement of Professor Beck*, *supra* note 38, at 104; ABA Proposal, *supra* note 37, at 5.

42. ABA Proposal, *supra* note 37, at 5.

43. See Angney, *supra* note 30, at 610–11; see also 1998 TREASURY REPORT, *supra* note 33, at 23–44 (reviewing various proposals).

44. Pub. L. No. 105-206, § 3201, 112 Stat. 734 (codified at 26 U.S.C. § 6015 (2000)).

45. See H.R. CONF. REP. NO. 105-599, at 249–52 (1998).

46. *Id.* at 249.

Section 6015 was the result of a compromise between different House and Senate versions of the bill.⁴⁹ The innocent spouse provision of the House bill preserved the basic framework of former § 6013(e) but lessened the requirements a spouse must meet to qualify for relief.⁵⁰ In particular, the House bill provided that the tax understatement no longer had to be substantial and required the understatement to be attributable to only erroneous—rather than grossly erroneous—items.⁵¹

In contrast, the Senate amendment liberalized the House bill.⁵² The Senate version rejected the constraints of the § 6013(e) framework and approached the relief provision on a different theoretical level, endorsing a separation of liability method⁵³ based on a proposal by the American Bar Association.⁵⁴ The separation of liability approach allowed a claimant spouse to sever his or her tax liability from that of the other spouse by allocating income, deductions, or credits as if they had filed separate returns.⁵⁵ Thus, liability for a tax deficiency caused by omitted income, an erroneous credit, or an erroneous deduction would follow only the person responsible for that error.⁵⁶ When Senator Graham presented the Senate amendment,⁵⁷ he explained that the Senate

47. See *Price v. Comm'r*, 887 F.2d 959, 963 n.9 (9th Cir. 1989) (stating that giving § 6013(e) an unduly narrow and restrictive reading would hinder Congress' broader purpose in seeking to remedy an injustice).

48. See *Cheshire v. Comm'r*, 115 T.C. 183, 201 (2000) (Parr, J., dissenting).

49. See Angney, *supra* note 30, at 614–15.

50. See H.R. REP. NO. 105-364, pt. 1, at 19, 60–61 (1997).

51. See *id.* at 61.

52. See S. REP. NO. 105-174, at 55–56 (1998); 144 CONG. REC. S4160–61 (daily ed. May 4, 1998).

53. See S. REP. NO. 105-174, at 56. This concept has been also referred to as (1) the “item” approach, ABA Proposal, *supra* note 37, at 7; *IRS Restructuring (Innocent Spouse Tax Rules): Hearing on H.R. 2676 Before the Senate Comm. on Finance*, 105th Cong., 2d Sess. 182 (1998) [hereinafter *IRS Restructuring Hearing*] (statement of Marjorie O’Connell, tax attorney, O’Connell & Associates); (2) the “division of liability” method, Brief of Amici Curiae in Favor of Reversal at 2, *Cheshire v. Comm'r*, 282 F.3d 326 (5th Cir. 2002) (No. 00-60855) [hereinafter *Cheshire Amici Brief*], available at <http://www.abanet.org/tax/groups/domrel/cheshirebrief.pdf> (last visited June 22, 2003); and (3) the “accounting” approach, 144 CONG. REC. S4474 (daily ed. May 7, 1998) (statement of Sen. Graham). This Comment uses the phrase *separation of liability* approach.

54. See ABA Proposal, *supra* note 37, at 6–7.

55. See S. REP. NO. 105-174, at 56.

56. See *id.* at 55–56.

57. Senators Graham, D’Amato, and Feinstein introduced an amendment to the actual knowledge exception, which became part of the final bill, to make actual knowledge relevant at the time an individual signed the return, and to remove cases of duress from the exception’s coverage. See 144 CONG. REC. S4473–74 (daily ed. May 7, 1998).

Committee on Finance had adopted the American Bar Association separation of liability approach to replace joint and several responsibility with “individual responsibility.”⁵⁸

A Conference Committee was appointed to resolve the disagreement between the House and Senate versions of the bill; the Committee successfully reached a compromise⁵⁹ that was approved by both houses.⁶⁰ The resulting 1998 amendment repealed § 6013(e) and replaced it with § 6015, which combined the House and Senate versions.⁶¹ The Senate’s liberal separation of liability relief was included, although it was limited to taxpayers who were divorced, separated, or had been living apart for at least one year.⁶² Further, the 1998 amendment included the House provision that modified the innocent spouse relief and was available to taxpayers who did not qualify for separation of liability relief.⁶³ The Conference Committee added the third form of relief to cover “appropriate situations to avoid the inequitable treatment of spouses” in the Secretary’s discretion.⁶⁴ The price of this compromise was the mixture of three forms of relief, each operating under different policies: prerequisite *innocence* and *equity* embedded in innocent spouse relief;⁶⁵ *individual responsibility* for a spouse’s own taxes underlying separation of liability relief;⁶⁶ and *inequity avoidance* under discretionary relief.⁶⁷

B. Section 6015 Transformed the Innocent Spouse Relief Under Former § 6013(e) into Three Forms of Relief

As a result of the Conference Committee’s compromise, § 6015 provides for three distinct types of relief that are codified at 26 U.S.C. § 6015(b), (c), and (f). The first avenue of relief, § 6015(b), is a reformed version of the former innocent spouse provision, § 6013(e),

58. See *id.* at S4474.

59. See H.R. CONF. REP. NO. 105-599, at 249–55 (1998).

60. See Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3201, 112 Stat. 734 (codified at 26 U.S.C. § 6015 (2000)).

61. 26 U.S.C. § 6015 (2000); see H.R. CONF. REP. NO. 105-599, at 251.

62. 26 U.S.C. § 6015(c)(3)(A)(i); see H.R. CONF. REP. NO. 105-599, at 251.

63. 26 U.S.C. § 6015(b); see H.R. CONF. REP. NO. 105-599, at 251.

64. H.R. CONF. REP. NO. 105-599, at 254; see 26 U.S.C. § 6015(f).

65. See *supra* text accompanying notes 36–42.

66. See *supra* text accompanying notes 53–58.

67. See *supra* text accompanying note 64.

while the other two provisions, § 6015(c) and (f), are completely new additions to the statute.⁶⁸

1. *Innocent Spouse Relief Under § 6015(b)*

Section 6015(b) provides innocent spouses with complete relief from liability if (1) a joint return has been made; (2) the tax understatement is attributable to the non-claimant spouse's erroneous items; (3) the claimant spouse proves that in signing the return he or she had no actual or constructive knowledge of the understatement; (4) it is inequitable to hold the claimant spouse liable for the tax deficiency; and (5) the claimant spouse elects the benefits of § 6015(b) within two years after the date the Secretary has begun collection activities.⁶⁹ In addition, partial relief is available if the claimant did not know and had no reason to know of the extent of the understatement.⁷⁰

Although it is based on former § 6013(e), § 6015(b) broadened the scope of its predecessor.⁷¹ The tax understatement is no longer required to be substantial, and the items to which it is attributable do not have to be grossly erroneous.⁷² However, the 1998 amendment preserved the innocence and equity requirements of former § 6013(e).⁷³

2. *Discretionary Relief Under § 6015(f)*

Section 6015(f) authorizes the Secretary to provide equitable relief at his or her discretion if it is unfair to hold the taxpayer liable.⁷⁴ Discretionary relief is authorized only if a requesting taxpayer cannot obtain either innocent spouse or separation of liability relief under § 6015(b) or (c).⁷⁵ The Secretary's determination must be made "taking into account all the facts and circumstances."⁷⁶ On review to the courts, the Secretary's determination is subject to the "abuse of discretion"

68. See *Cheshire v. Comm'r*, 282 F.3d 326, 331 n.9 (5th Cir. 2002).

69. See 26 U.S.C. § 6015(b)(1).

70. *Id.* § 6015(b)(2). Before the 1998 amendment, it was unclear whether a court could grant partial innocent spouse relief. 1998 BACKGROUND REPORT, *supra* note 34, at 6 (citing *Wiksell v. Comm'r*, 90 F.3d 1459 (9th Cir. 1997)).

71. H.R. CONF. REP. NO. 105-599, at 254 (1998).

72. 26 U.S.C. § 6015(b)(1)(B).

73. *Id.* § 6015(b)(1)(C)-(D); see also *supra* notes 36-37, 40-41 and accompanying text.

74. 26 U.S.C. § 6015(f).

75. *Id.* § 6015(f)(2).

76. *Id.* § 6015(f)(1).

standard.⁷⁷ In order to prevail, taxpayers appealing the denial of discretionary relief must demonstrate that the Secretary exercised his or her discretion arbitrarily, capriciously, or without sound basis in fact or law.⁷⁸

3. *Separation of Liability Relief Under § 6015(c)*

Unlike innocent spouse relief under § 6015(b) and discretionary relief under § 6015(f), which are available to any spouse who meets the prescribed statutory requirements, separation of liability relief is only available to taxpayers who are divorced, legally separated, or living apart for at least one year.⁷⁹ This avenue of relief is thus limited to a small percentage of the total number of taxpayers who apply for relief from joint and several liability.⁸⁰ Congress believed that an elective system based on separate liability would provide better protection for this class of taxpayers⁸¹ because the inequities experienced by taxpayers facing collection attempts by the Internal Revenue Service (the Service) are most appalling in cases of divorce or separation.⁸²

Josephine Berman's story, related to the Senate Committee on Finance, is such a case.⁸³ Although her husband left her in 1970, the Service tried for years to recover a joint tax deficiency that was created when the Service disallowed her husband's deductions for legal

77. See, e.g., *Cheshire v. Comm'r*, 282 F.3d 326, 338 (5th Cir. 2002); *Alt v. Comm'r*, 119 T.C. 306, 316 (2002); *Cheshire v. Comm'r*, 115 T.C. 183, 198 (2000).

78. *Woodral v. Comm'r*, 112 T.C. 19, 23 (1999).

79. 26 U.S.C. § 6015(c)(3)(A)(i).

80. As of March 6, 2001, only 11% of the total number of meritorious innocent spouse claims were received and decided by the Service under § 6015(c). See JOINT COMM. ON TAXATION, 106TH CONG., REPORT RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998, JCX-33-01, at 61 n.250 (J. Comm. Print 2001) [hereinafter 2001 JOINT COMM. REPORT].

81. See H.R. CONF. REP. NO. 105-599, at 251-52 (1998); S. REP. NO. 105-174, at 55 (1998); see also STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., 2D SESS., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998 70 (J. Comm. Print 1998) [hereinafter GENERAL EXPLANATION].

82. See *IRS Restructuring Hearing*, *supra* note 53, at 144-65 (statements of Elizabeth Cockrell, Svetlana Pejanovic, Karen J. Andreasen, and Josephine Berman, taxpayers); 1998 TREASURY REPORT, *supra* note 33, at 49; see also Beck, *supra* note 1, at 328-30 (discussing the harshness and unfairness of joint and several liability on separated or divorced women); Robert D. Hershey Jr., *Married, Filing Jointly, with an I.R.S. Headache*, N.Y. TIMES, Feb. 8, 1998, at 10BU (describing the hardships experienced by Josephine Berman and Elizabeth Cockrell).

83. *IRS Restructuring Hearing*, *supra* note 53, at 153-55 (statement of Josephine Berman, taxpayer).

expenses incurred during litigation with his partner in an S corporation and claimed on the Bermans' 1968, 1969, and 1970 joint returns.⁸⁴ At the time of Ms. Berman's testimony in 1998, the Service had placed a lien on her home, destroyed her credit rating, and seized her retirement savings.⁸⁵ In part because of stories of inequities suffered by taxpayers like Ms. Berman, the Senate Committee adopted the separation of liability relief provision.⁸⁶ Although this provision allows taxpayers to separate their joint tax liability as if they had filed separate returns, there are procedural and substantive limitations on its availability to taxpayers.

a) Operation of § 6015(c)

Section 6015(c) is based on the separation of liability approach proposed by the ABA, "in which liability for the tax follows responsibility for the item, and represents a departure from strictly proportional liability."⁸⁷ Separation of liability relief allows spouses to divide their joint tax deficiency through the allocation of items of income, deduction, and credit.⁸⁸ When a taxpayer requests relief under § 6015(c), each item giving rise to a tax deficiency must first be allocated to each spouse as if the spouses had filed separate returns.⁸⁹ Next, the claimant's tax liability for those items is calculated.⁹⁰ For example, if the Service assesses a deficiency attributable to \$70,000 of the husband's unreported income and \$30,000 of the wife's disallowed deductions, and the husband is qualified to elect separation of liability

84. *Id.* at 153–54. Apparently, the Service concluded the claimed deductions were disallowed because they were incurred to protect Mr. Berman's equity investment rather than his income interest. *Id.* at 153.

85. *Id.* at 154–55.

86. See S. REP. NO. 105-174, at 55.

87. ABA Proposal, *supra* note 37, at 7; see also 144 CONG. REC. S4474 (daily ed. May 7, 1998) (statement of Sen. Graham).

88. See 26 U.S.C. § 6015(d) (2000).

89. *Id.* § 6015(d)(3)(A) ("[A]ny item giving rise to a deficiency on a joint return shall be allocated to individuals filing the return in the same manner as it would have been allocated if the individuals had filed separate returns for the taxable year.") (emphasis added). There are two exceptions to this general allocation rule: (1) a tax benefit to the claimant under § 6015(d)(3)(B), see *infra* note 92; and (2) fraud of one or both individuals authorizing the Secretary to provide for a different allocation under § 6015(d)(3)(C).

90. *Id.* § 6015(d)(1) ("The portion of any deficiency on a joint return allocated to an individual shall be the amount which bears the same ratio to such deficiency as the net amount of items taken into account in computing the deficiency and allocable to the individual under paragraph (3) bears to the net amount of all items taken into account in computing the deficiency.").

relief under § 6015(c),⁹¹ then his liability would be limited to seventy percent of the total tax deficiency.⁹²

b) Limitations on § 6015(c)'s Availability

Congress has set several limitations on the availability of the separation of liability relief provision. Section 6015 imposes two technical limitations: (1) a taxpayer's request for relief must be made within two years from the beginning of the Service's collection activities,⁹³ and (2) no credit or refund is available as a result of the § 6015(c) election.⁹⁴ Further, there are three additional limitations, so-called "special rules,"⁹⁵ that are intended to prevent inappropriate use of separation of liability relief.⁹⁶ These limitations originated in the Senate amendment and were incorporated into the final bill by the Conference agreement.⁹⁷ First, neither spouse can elect to separate liability if assets were transferred between the spouses as part of a fraudulent scheme joined in by both spouses.⁹⁸ Second, if the spouses transferred disqualified assets for the principal purpose of tax avoidance, the liability of the electing spouse is increased by the value of any assets so

91. See *id.* § 6015(c)(3)(A)(i).

92. See H.R. CONF. REP. NO. 105-599, at 252 (1998).

However, if the claimant spouse's deductions exceed the other spouse's income, the claimant is liable for the excess deductions from which he or she has benefited. 26 U.S.C. § 6015(d)(3)(B) ("[A]n item otherwise allocable to an individual under subparagraph (A) shall be allocated to the other individual filing the joint return to the extent the item gave rise to a tax benefit on the joint return to the other individual.") (emphasis added).

For example, assume a \$20,000 disallowed deduction, entirely allocated to the husband, resulted in a \$5,600 deficiency. The joint return listed \$100,000 of wage income and \$15,000 of self-employment income allocable to the wife and husband respectively. Because the disallowed deduction entirely offsets the \$15,000 of the husband's income, the remaining \$5,000 of the \$20,000 deduction offsets the wife's income. The liability for the deficiency is divided in proportion to the amount of income offset for each spouse: the husband is liable for three-fourths of the deficiency (\$4,200), and the wife is liable for the remaining one-fourth (\$1,400). See H.R. CONF. REP. NO. 105-599, at 252-53.

93. 26 U.S.C. § 6015(c)(3)(B). An individual must elect limited liability under § 6015(c); if no election has been made, the individual is still responsible for the full amount of the deficiency. See H.R. CONF. REP. NO. 105-599, at 252.

94. 26 U.S.C. § 6015(g)(3).

95. See H.R. CONF. REP. NO. 105-599, at 253; S. REP. NO. 105-174, at 59 (1998).

96. 26 U.S.C. § 6015(c)(3)(A)(ii), (c)(3)(C), (c)(4).

97. See H.R. CONF. REP. NO. 105-599, at 253; S. REP. NO. 105-174, at 59.

98. See 26 U.S.C. § 6015(c)(3)(A)(ii).

transferred.⁹⁹ Third, if an electing spouse had actual knowledge of “any item giving rise to a deficiency” at the time he or she signed the return, separation of liability relief is not available for any tax deficiency that is attributed to that item (the actual knowledge exception).¹⁰⁰ The Service has the burden of showing that a claimant has actual knowledge of an item giving rise to a deficiency.¹⁰¹

In sum, § 6015(c)’s allocation rules allow a claimant spouse to separate his or her liability for a jointly owed tax deficiency. Separation of liability relief is only available to a limited class of taxpayers, and is subject to many procedural and substantive limitations. Notably, if taxpayers had actual knowledge of any item giving rise to a deficiency, they cannot separate liability for that deficiency.

II. TWO INTERPRETATIONS OF THE ACTUAL KNOWLEDGE EXCEPTION TO § 6015(c): UNDERLYING TRANSACTION AND ITEM ON A RETURN

Spouses with actual knowledge of any “item giving rise to a deficiency” cannot obtain separation of liability relief for that deficiency.¹⁰² Congress’ use of that phrase has sparked disagreement over what “item” the taxpayer can know about to qualify for relief. The United States Courts of Appeals for the Fifth Circuit and District of Columbia Circuit, as well as the United States Tax Court, have all agreed with the Service and adopted the underlying transaction interpretation, thus barring taxpayers from obtaining relief if they knew about the transaction that gave rise to a tax deficiency.¹⁰³ However, Judge Colvin agreed with the taxpayers in his dissent from the Tax Court opinion and determined that this statutory phrase means an “item on the return” so that the actual knowledge exception would bar relief only if taxpayers knew that they were signing a joint return containing an incorrectly claimed item.¹⁰⁴

99. *See id.* § 6015(c)(4).

100. *See id.* § 6015(c)(3)(C).

101. *See id.*

102. *Id.* (“If the Secretary demonstrates that an individual making an election under this subsection had actual knowledge, at the time such individual signed the return, of any item giving rise to a deficiency (or portion thereof) which is not allocable to such individual under subsection (d), such election shall not apply to such deficiency (or portion).”).

103. *See Mitchell v. Comm’r*, 292 F.3d 800, 806 (D.C. Cir. 2002); *Cheshire v. Comm’r*, 282 F.3d 326, 337 (5th Cir. 2002); *Cheshire v. Comm’r*, 115 T.C. 183, 195 (2000); *see also supra* note 20.

104. *See Cheshire*, 115 T.C. at 206–07 (Colvin, J., dissenting); *see also supra* note 21.

A. The Underlying Transaction Interpretation

The first case to address this issue arose in the Fifth Circuit. In *Cheshire v. Commissioner*,¹⁰⁵ Kathryn Cheshire's husband received retirement distributions, more than half of which were used to pay off the Cheshires' home mortgage and buy a new family car.¹⁰⁶ On the joint return for that year, the Cheshires incorrectly claimed that only a small portion of the retirement distributions was taxable.¹⁰⁷ Before signing the return, Mrs. Cheshire questioned her husband about the tax consequences of the retirement distributions, and he replied that an accountant advised him that the proceeds used to pay off the mortgage were nontaxable.¹⁰⁸ In fact, he had never consulted an accountant, and the proceeds were taxable.¹⁰⁹ The Cheshires subsequently divorced, and Mrs. Cheshire received the house and family car under a divorce decree.¹¹⁰ Consequently, under the joint and several liability that arises from filing a joint return, the Service assessed a deficiency against Mrs. Cheshire for understating the taxable amount of the retirement distributions and other income.¹¹¹

Mrs. Cheshire argued that § 6015(c) should relieve her of joint and several liability because the phrase "item giving rise to a deficiency" means "incorrect tax reporting of an item."¹¹² In other words, she contended that § 6015(c) relief should be available to her because she did not have actual knowledge that the joint tax return incorrectly omitted the retirement funds that should have been taxed.¹¹³ Affirming the Tax Court's decision, the Fifth Circuit disagreed with Mrs. Cheshire and held that "item" refers to "an item of income, deduction, or credit."¹¹⁴ Thus, the Fifth Circuit adopted the underlying transaction interpretation of "item" under § 6015(c) and held that Mrs. Cheshire could not separate her liability because she had "actual and clear awareness" of Mr. Cheshire's retirement distributions and knew how the

105. 282 F.3d 326 (5th Cir. 2002).

106. *Id.* at 329–30.

107. *Id.* at 330.

108. *Id.*

109. *Id.*; see 26 U.S.C. § 61(a)(11) (2000).

110. *Cheshire*, 282 F.3d at 330.

111. *Id.* at 329–30.

112. *Id.* at 335; see also *supra* note 21.

113. See *Cheshire*, 282 F.3d at 335.

114. *Id.* at 337; see also *supra* note 20.

distributions were spent.¹¹⁵ In reaching its decision, the Fifth Circuit relied on the plain meaning of the term “item” in § 6015 and other sections of the Internal Revenue Code (the Code) to support the meaning adopted by the court.¹¹⁶ Additionally, the court suggested that Mrs. Cheshire’s interpretation “runs afoul of the general rule that ignorance of the tax laws is not a defense to a tax deficiency.”¹¹⁷ Because the court found that the statute was not ambiguous on its face, it declined to give any deference to § 6015’s “inconclusive” and “ambiguous” legislative history.¹¹⁸

Both the Fifth Circuit and the Tax Court relied on the principle that ignorance of the law is not a defense in rejecting Mrs. Cheshire’s argument.¹¹⁹ However, unlike the Tax Court, the Fifth Circuit did not recognize that a conflict existed between its interpretation of “item” and numerous references in the legislative history of § 6015(c).¹²⁰ The majority of the Tax Court resolved this conflict in favor of a broader reading of the actual knowledge exception, relying in part on a self-employment example in the report issued by the Joint Committee on Taxation for the 1998 amendment.¹²¹ The example posits a husband with \$20,000 of unreported self-employment income, \$5,000 of which his wife knew about,¹²² and concludes that after the divorce, the wife could not use § 6015(c) to separate joint and several liability for the \$5,000, of which she knew, although she could do so for the remaining \$15,000, of which she did not know.¹²³ The Tax Court concluded that in omitted income situations, a taxpayer who actually knows about “the item of

115. *Cheshire*, 282 F.3d at 337; see also *supra* note 20.

116. See *Cheshire*, 282 F.3d at 335–36 (citing 26 U.S.C. § 6015(b)(1)(B) (2000), which refers to “an understatement of tax attributable to erroneous items of one individual,” and 26 U.S.C. § 61(a), which defines “gross income” to include such “items” as compensation for services, interest, rents, and royalties).

117. *Id.* at 336. The principle that *ignorance of the law is not a defense* describes the courts’ rejection of a taxpayer’s claim for relief when the claimant “had all the facts at her disposal and merely did not know the item was taxable or nondeductible.” Jerome Borison, *Innocent Spouse Relief: A Call for Legislative and Judicial Liberalization*, 40 TAX LAW. 819, 834 (1987).

118. *Cheshire*, 282 F.3d at 336–37.

119. See *id.* at 336; *Cheshire v. Comm’r*, 115 T.C. 183, 196–97 (2000).

120. See *Cheshire*, 282 F.3d at 337; *Cheshire*, 115 T.C. at 195.

121. *Cheshire*, 115 T.C. at 195–96 (citing GENERAL EXPLANATION, *supra* note 81, at 70). This self-employment income example was included without variation in the Senate report, see S. REP. NO. 105-174, at 58 (1998), and the Conference Committee report, see H.R. CONF. REP. NO. 105-599, at 252–53 (1998).

122. See *Cheshire*, 115 T.C. at 196.

123. See *id.*

income that should have been reported on the return” has actual knowledge of an item giving rise to the deficiency; such taxpayer is therefore ineligible for separation of liability relief.¹²⁴

The Court of Appeals for the District of Columbia Circuit reached a similar conclusion in *Mitchell v. Commissioner*.¹²⁵ In *Mitchell*, the taxpayer Mrs. Mitchell lost her husband who, prior to his sudden death, received a retirement distribution and used the proceeds to purchase treasury securities.¹²⁶ Mrs. Mitchell knew about the distribution and what her husband did with it, although she did not know the correct tax treatment of the distribution on a return.¹²⁷ The Service assessed a tax deficiency against Mrs. Mitchell, but she argued that she should receive separation of liability relief because the actual knowledge exception should only apply if she knew that the retirement distributions were not properly reported.¹²⁸

The court rejected Mrs. Mitchell’s argument and held that the Service was not required to prove that she had actual knowledge of the improper tax treatment of an item.¹²⁹ The *Mitchell* court relied on the literal meaning of the phrase “item giving rise to a deficiency” and rejected Mrs. Mitchell’s interpretation as “semantically awkward.”¹³⁰ Like the *Cheshire* court, the *Mitchell* court considered the principle that ignorance of the law is not a defense, and held that it was “unlikely that Congress would have employed such subtle and ambiguous phrasing” to overrule this well-established concept.¹³¹ The court also noted that the remedial purposes of § 6015 were satisfied by shifting the burden of proving Mrs. Mitchell’s actual knowledge of the item to the Service and by requiring the Service to prove actual, and not merely constructive, knowledge.¹³² In sum, in adopting the underlying transaction interpretation, courts have primarily relied on the plain meaning of the word “item” and the principle that ignorance of the law is not a defense.

124. *Id.* at 195.

125. 292 F.3d 800 (D.C. Cir. 2002).

126. *Id.* at 801.

127. *Id.* at 801–02.

128. *See id.* at 805.

129. *Id.* at 806.

130. *Id.* at 805.

131. *Id.*

132. *See id.* at 805–06; *see also* 26 U.S.C. § 6015(c)(3)(C) (2000).

B. *The Item on a Return Interpretation*

Dissenting from the Tax Court's decision in *Cheshire*,¹³³ Judge Colvin agreed with the taxpayer's interpretation of "item" and concluded that the history and context of § 6015(c) required the Service to prove a taxpayer's actual knowledge that an item was incorrectly reported on a return.¹³⁴ Judge Colvin reasoned that the legislative history consistently supported this interpretation, pointing to the Senate Committee on Finance report, which stated that: "if the IRS proves that *the electing spouse had actual knowledge that an item on a return is incorrect*, the election will not apply to the extent any deficiency is attributable to such item."¹³⁵ Further, another portion of the report stated:

"The Committee intends that this election [to separate liability] be available to limit the liability of spouses for tax attributable to items of which they had no knowledge. The Committee is concerned that taxpayers not be allowed to abuse these rules *by knowingly signing false returns*, or by transferring assets for the purpose of avoiding the payment of tax by the use of this election."¹³⁶

Thus, Judge Colvin determined that the Senate Committee intended the actual knowledge exception to apply to taxpayers who knew that a return was incorrect—in other words, to taxpayers who were "knowingly signing false returns."¹³⁷

In addition, Judge Colvin considered the floor remarks by Senators Graham and D'Amato persuasive.¹³⁸ Both senators were members of the Senate Committee on Finance, and they introduced the amendments to the actual knowledge exception.¹³⁹ Senator Graham commented that the Secretary had the burden of demonstrating that a spouse making a § 6015(c) election "*had actual knowledge of the conditions within that return which led to this deficiency*" in order to be "100 percent responsible."¹⁴⁰ Similarly, Senator D'Amato explained the policy

133. *Cheshire v. Comm'r*, 115 T.C. 183, 202–09 (2000).

134. *Id.* at 203–07.

135. *Id.* at 204–05 (quoting S. REP. NO. 105-174, at 59 (1998)).

136. *Id.* at 205 (quoting S. REP. NO. 105-174, at 55–56).

137. *Id.* at 205–06.

138. *Id.* at 205.

139. See *supra* note 57.

140. *Cheshire*, 115 T.C. at 205 (Colvin, J., dissenting) (quoting 144 CONG. REC. S4474 (daily ed. May 7, 1998)).

behind the actual knowledge exception as alleviating lawmakers' concerns "'that some taxpayers may try to abuse the innocent spouse rules by knowingly signing false returns, or transferring assets for the purpose of avoiding the payment of tax, and then claim to be innocent.'"¹⁴¹ Because "'no one would want to open the door to that type of fraud,'" the actual knowledge exception was included in the bill.¹⁴²

Finally, Judge Colvin noted that the language used by the Conference Committee¹⁴³ was identical to that used by the Senate Committee,¹⁴⁴ and determined that this legislative history "unequivocally show[ed]" Congress' intent to require the Commissioner to prove that the spouse knew his or her tax return was incorrect.¹⁴⁵ Accordingly, Judge Colvin concluded that "Congress intended the knowledge requirement to mean knowledge that the return is incorrect, not knowledge that there was an income-producing activity or transaction."¹⁴⁶

C. Treasury Regulations

Having won in *Cheshire* and *Mitchell*, the Service, acting through the Treasury, promptly fortified its foothold with the Final Regulations, published on July 18, 2002.¹⁴⁷ The Regulations interpret the actual knowledge exception differently depending on whether a case involves omitted income, an erroneous deduction, or fictitious or inflated deductions or credits.¹⁴⁸ For cases where a spouse omits income, the Service adopted the holding of the Tax Court in *Cheshire*.¹⁴⁹ In such cases, the standard is whether the requesting spouse actually knew about the item, including the receipt of the income,¹⁵⁰ rather than simply knowing about the tax consequences of the item.¹⁵¹ On the other hand, in cases where a spouse has claimed an erroneous deduction, the Service

141. *Id.* (quoting 144 CONG. REC. S4474).

142. *Id.* (quoting 144 CONG. REC. S4474).

143. H.R. CONF. REP. NO. 105-599, at 253 (1998).

144. *See supra* text accompanying note 135.

145. *Cheshire*, 115 T.C. at 206 (Colvin, J., dissenting).

146. *Id.* at 206-07 (citations omitted).

147. Relief from Joint and Several Liability, 67 Fed. Reg. 47,278 (July 18, 2002) (to be codified at 26 C.F.R. pts. 1, 602); *see also* 26 U.S.C. § 6015(h) (2000).

148. *See* Treas. Reg. § 1.6015-3(c)(2)(i) (2002); Summary of Comments and Explanation of Revisions, 67 Fed. Reg. 47,278, 47,282-83 (July 18, 2002).

149. *See* Summary of Comments and Explanation of Revisions, 67 Fed. Reg. at 47,282.

150. Treas. Reg. § 1.6015-3(c)(2)(i)(A).

151. Summary of Comments and Explanation of Revisions, 67 Fed. Reg. at 47,282.

adopted a standard developed by the Tax Court in *King v. Commissioner*,¹⁵² where the relevant inquiry is whether the requesting spouse actually knew about the factual circumstances that made the item unallowable as a deduction, rather than the proper tax consequences of the item.¹⁵³ In cases involving fictitious or inflated deductions or credits, the standard is whether the spouse actually knew that the expenditure was not incurred, or not incurred to that extent.¹⁵⁴

Before these Regulations became final, commentators criticized the Service's interpretation of the actual knowledge exception, claiming that it was contrary to the provision's legislative history.¹⁵⁵ However, the Service reasoned that narrowing these standards would give the actual knowledge exception a superfluous meaning.¹⁵⁶ The Service also rejected these criticisms based on the self-employment income example contained in the legislative history.¹⁵⁷ The Service read this example to refer to both the income tax *and* the self-employment tax deficiency attributable to the \$5,000 portion of the self-employment income about which the wife had actual knowledge.¹⁵⁸ While the wife's knowledge of her husband's self-employment income might also imply that she knew that the omitted \$5,000 is subject to income tax, it does not mean that she is aware of an additional self-employment tax on the omitted income because many taxpayers are unaware of that tax.¹⁵⁹ Because this example did not indicate that the Service must prove that the wife actually knew that self-employment income was subject to income tax *and*

152. 116 T.C. 198, 204 (2001).

153. See Treas. Reg. § 1.6015-3(c)(2)(i)(B)(1); Summary of Comments and Explanation of Revisions, 67 Fed. Reg. at 47,283.

154. Treas. Reg. § 1.6015-3(c)(2)(i)(B)(2).

155. See, e.g., *Unofficial Transcript of IRS Hearing on Innocent Spouse Regs.*, 2001 TAX NOTES TODAY 112-100 (June 11, 2001) [hereinafter *June 2001 IRS Hearing*] (statement of David L. Keating, Senior Counsel, National Taxpayers Union); *AICPA Suggests Changes to Innocent Spouse Regs.*, 2001 TAX NOTES TODAY 133-26 (July 11, 2001).

156. See *June 2001 IRS Hearing*, *supra* note 155, ¶¶ 102, 107 (remarks of Judy Wall, Branch Chief, IRS Procedure and Administration) ("In that legislative history where they talk about knowingly signing false returns, . . . there are several limitations in the statute. One of which is fraud . . . I'm having trouble understanding why we would have needed the separate, actual knowledge limitation if we already had the fraud limitation . . .").

157. See *supra* text accompanying notes 121-23.

158. See Summary of Comments and Explanation of Revisions, 67 Fed. Reg. at 47,282; *accord June 2001 IRS Hearing*, *supra* note 155, ¶¶ 108, 111-12 (remarks of Bridget Finkenauf, Attorney-Advisor, IRS Procedure and Administration).

159. See *June 2001 IRS Hearing*, *supra* note 155, ¶¶ 108, 111-12 (remarks of Bridget Finkenauf, Attorney-Advisor, IRS Procedure and Administration).

self-employment tax, the Service rejected the standard that actual knowledge of the item means actual knowledge of the proper tax treatment of the item.¹⁶⁰

Contrary to the Regulations' approach, the National Taxpayer Advocate, the head of the Service's Taxpayer Advocate Service, recommended eliminating the actual knowledge requirement from § 6015(c) because it "frustrates [c]ongressional intent" to have separation of liability relief as "a largely mechanical application of law that permits divorced or separated taxpayers to end their joint financial obligation to the IRS."¹⁶¹ According to the National Taxpayer Advocate's statistics, the denial rate of all claims under the actual knowledge standard is only slightly lower than the denial rates under the constructive knowledge standard, even though the constructive knowledge standard, which is more difficult for a claimant spouse to prove, should logically lead to significantly higher denial rates.¹⁶²

Courts and the Treasury have interpreted the actual knowledge exception under § 6015(c) to disallow separation of liability relief to claimants with actual knowledge of an underlying transaction.¹⁶³ In contrast, Judge Colvin's dissent in *Cheshire* urged a pro-taxpayer interpretation of this exception, under which only claimants who knew they had signed an incorrect return would be barred from § 6015(c) relief.¹⁶⁴ Additionally, the Regulations' approach, interpreting the actual knowledge exception as three different standards, has been met with substantial criticism from both commentators and the National Taxpayer Advocate.¹⁶⁵

160. See Summary of Comments and Explanation of Revisions, 67 Fed. Reg. at 47,282.

161. 2000 NATIONAL TAXPAYER ADVOCATE'S ANNUAL REPORT TO CONGRESS 91, available at <http://www.irs.gov/pub/irs-utl/pub2104-2000.pdf> (last visited July 26, 2003); accord 2001 JOINT COMM. REPORT, *supra* note 80, at 61 n.250 (citing Letter from IRS to the Joint Comm. Staff (Apr. 27, 2001)).

162. 2000 NATIONAL TAXPAYER ADVOCATE'S ANNUAL REPORT TO CONGRESS, *supra* note 161, at 91.

163. See *supra* Part II.A, C.

164. See *supra* Part II.B.

165. See *supra* notes 155, 161–62 and accompanying text.

III. THE CONSTRUCTIVE OR ACTUAL KNOWLEDGE REQUIREMENT UNDER § 6015(b) AND FORMER § 6013(e) INNOCENT SPOUSE RELIEF

Although § 6015(c) separation of liability relief has no statutory antecedent,¹⁶⁶ there is a significant body of case law interpreting § 6015(b)'s and former § 6013(e)'s requirement that to be innocent, taxpayers must have no actual or constructive knowledge of a tax understatement.¹⁶⁷ In rejecting the taxpayers' interpretation of "item" in § 6015(c), the *Cheshire* and *Mitchell* courts relied in part on the general principle that ignorance of the law is not a defense.¹⁶⁸ Courts used this same principle in interpreting the knowledge requirements of § 6015(b)¹⁶⁹ and former § 6013(e).¹⁷⁰

A. Two Standards for Two Lines of Cases

The knowledge element of former § 6013(e) required spouses signing a joint return to not know, and have no reason to know, that there was a substantial understatement of tax.¹⁷¹ Courts developed two different standards for the meaning of "understatement," drawing a line between cases involving omitted income and cases involving erroneous deductions.¹⁷² Courts have agreed that in omission of income cases, the claimant spouse must not know or have reason to know of the underlying transaction that produced the income (the knowledge of the transaction test).¹⁷³ But in erroneous deduction cases, courts are divided: the Tax Court continues to apply the same knowledge of the transaction test,¹⁷⁴ while some circuit courts have adopted an alternate test announced by the United States Court of Appeals for the Ninth Circuit in *Price v. Commissioner*.¹⁷⁵ The *Price* standard goes beyond evaluating

166. See *Mitchell v. Comm'r*, 292 F.3d 800, 804 (D.C. Cir. 2002).

167. See *Beck*, *supra* note 1, at 352–56.

168. *Mitchell*, 292 F.3d at 805; *Cheshire v. Comm'r*, 282 F.3d 326, 336 (5th Cir. 2002).

169. See, e.g., *Mitchell*, 292 F.3d at 804; *Cheshire*, 282 F.3d at 334–35.

170. See, e.g., *Price v. Comm'r*, 887 F.2d 959, 964 (9th Cir. 1989).

171. See 26 U.S.C. § 6013(e)(1)(C) (1994) (current version at 26 U.S.C. § 6015 (2000)); see also *supra* text accompanying note 29. The 1998 amendment deleted the word "substantial." GENERAL EXPLANATION, *supra* note 81, at 71; see also 26 U.S.C. § 6015(b)(1)(C) (2000).

172. See *Cheshire*, 282 F.3d at 333.

173. *Id.*

174. See *id.* (citing *Bokum v. Comm'r*, 94 T.C. 126, 151 (1990)).

175. 887 F.2d 959 (9th Cir. 1989). See *Cheshire*, 282 F.3d at 333.

the spouse's knowledge of the transaction underlying a deduction, and instead considers whether a reasonably prudent taxpayer in the spouse's position could be expected to know of the understatement.¹⁷⁶

Although the *Price* court expanded the relief available to a spouse in erroneous deduction cases, it cautioned that "[o]f itself, ignorance of the attendant legal or tax consequences of an item which gives rise to a deficiency is no defense for one seeking to obtain innocent spouse relief."¹⁷⁷ Courts have consistently rejected the theory that a person's ignorance of the tax consequences of his or her actions should be considered a factor in the application of the knowledge requirement.¹⁷⁸ However, the other factors applied by courts vary widely.¹⁷⁹ In determining whether the spouse has no knowledge of the understatement, courts have considered a claimant spouse's level of education, involvement in the family business or finances, the culpable spouse's deceit and ability to fool others, the culpable spouse's indictment or conviction on a related offense, and the lavishness of the family's expenditures compared to past spending patterns and standard of living.¹⁸⁰

B. Courts Uniformly Apply the Principle That Ignorance of the Law Is Not a Defense

While courts acknowledge that the knowledge of the transaction test conflicts with the plain meaning of the innocent spouse provision, which limits relief to spouses with no knowledge of the understatement,¹⁸¹ they nonetheless accept this deviation from the statute's plain meaning because "it avoids 'acceptance of an ignorance of the law defense.'"¹⁸² The principle that ignorance of the law is not a defense is both well-established¹⁸³ and solidly rooted in common law.¹⁸⁴

176. See *Price*, 887 F.2d at 963, 965.

177. See *id.* at 963–64.

178. See Borison, *supra* note 117, at 833–34.

179. See *id.* at 831–34; Beck, *supra* note 1, at 351–56.

180. See Borison, *supra* note 117, at 830–34.

181. See *Price*, 887 F.2d at 963 n.9; *Sanders v. United States*, 509 F.2d 162, 169 n.14 (5th Cir. 1975).

182. *Cheshire v. Comm'r*, 282 F.3d 326, 333 n.16 (5th Cir. 2002) (citing *Price*, 887 F.2d at 963 n.9; *Sanders*, 509 F.2d at 169 n.14).

183. See *Mitchell v. Comm'r*, 292 F.3d 800, 805 (D.C. Cir. 2002).

184. See Borison, *supra* note 117, at 834.

The seminal case establishing this principle in the innocent spouse context is *McCoy v. Commissioner*.¹⁸⁵ In *McCoy*, the Tax Court denied innocent spouse relief to a wife who was unaware of the tax consequences of income realized by her husband when he incorporated a partnership with assumed liabilities exceeding the basis of assets transferred.¹⁸⁶ The *McCoy* court rooted its decision in the legislative history of § 6013(e), which required “complete ignorance of the omission [of income]” before taxpayers could qualify for innocent spouse relief.¹⁸⁷

Relying on the congressional mandate of complete innocence for § 6013(e) relief, other courts have followed *McCoy* and held that ignorance of the law cannot be a defense to tax violations. These courts have charged claimants with a duty to inquire into the proper tax treatment of omitted income, claimed deductions, and credits.¹⁸⁸ The *Price* court suggested that where a spouse admitted knowing about unreported funds her husband had embezzled, but did not know that embezzled funds constituted taxable income, “she is considered as a matter of law to *have reason to know* of the substantial understatement and thereby is effectively precluded from establishing to the contrary.”¹⁸⁹ Further, the courts recognized the practical problems associated with using the ignorance of the law defense in the criminal law and federal income tax law,¹⁹⁰ such as the difficulty of refuting the defense and determining whether the claimant was at fault by not knowing the law.¹⁹¹

When the *Cheshire* and *Mitchell* courts rejected the item on a return interpretation of the term “item,” both courts relied in part on the principle that ignorance of the law is not a defense.¹⁹² The principle was

185. 57 T.C. 732 (1972).

186. See *id.* at 733–35 (citing 26 U.S.C. § 357(c) (1970)).

187. *Id.* at 734–35 (alteration in original).

188. See *Price v. Comm’r*, 887 F.2d 959, 966 (9th Cir. 1989); accord *Reser v. Comm’r*, 112 F.3d 1258, 1267–68 (5th Cir. 1997) (charging a spouse with a duty to inquire); *Von Kalinowski v. Comm’r*, 81 T.C.M. (CCH) 1081, 1086 (2001) (noting that “where a spouse has a duty to inquire as to the legitimacy of a deduction, failure to satisfy such duty may result in constructive knowledge of the understatement being imputed to her”).

189. *Price*, 887 F.2d at 964 (emphasis added).

190. See *Sanders v. United States*, 509 F.2d 162, 169 n.14 (5th Cir. 1975) (citing WAYNE R. LAFAVE & AUSTIN W. SCOTT, JR., HANDBOOK ON CRIMINAL LAW § 47, at 363–64 (1972)).

191. See LAFAVE & SCOTT, *supra* note 190, at 363–64.

192. *Mitchell v. Comm’r*, 292 F.3d 800, 805 (D.C. Cir. 2002); *Cheshire v. Comm’r*, 282 F.3d 326, 336 (5th Cir. 2002).

previously applied as part of the innocence requirement under the innocent spouse relief provision. The *Cheshire* and *Mitchell* courts extended this principle to separation of liability cases under new § 6015(c).¹⁹³

IV. THE PHRASE “ITEM GIVING RISE TO A DEFICIENCY” SHOULD BE INTERPRETED AS AN ITEM OF INCOME, DEDUCTION, OR CREDIT INCORRECTLY REPORTED ON A RETURN

Although courts have demonstrated their unwillingness to interpret the actual knowledge exception narrowly to give an electing taxpayer broader protection with separation of liability relief,¹⁹⁴ this hesitation is unjustifiable. The structure, text, and legislative history of the actual knowledge exception indicate that an “item giving rise to a deficiency” means an item of income, deduction, or credit incorrectly reported on a return.¹⁹⁵ Therefore, the actual knowledge exception should be limited only to those spouses who, at the time of signing a joint return, knew that the item was incorrectly reported on the return.¹⁹⁶ Rejecting the item on a return interpretation, the Treasury’s Regulations have created three knowledge tests.¹⁹⁷ However, these tests have no support in the text, structure, or legislative history of § 6015(c).¹⁹⁸ Additionally, policy considerations strongly favor adopting a narrow reading of the knowledge exception, thereby permitting taxpayers to obtain separation of liability relief unless they have actual knowledge that an item was incorrectly reported on a tax return.¹⁹⁹ Congress and the Treasury should amend § 6015(c) and the Regulations, respectively, to clearly state that the actual knowledge exception requires the Secretary to demonstrate that at the time of signing the joint return, the taxpayer knew that the item was reported incorrectly.²⁰⁰

193. *Mitchell*, 292 F.3d at 805; *Cheshire*, 282 F.3d at 336; *Cheshire v. Comm’r*, 115 T.C. 183, 196–97 (2000).

194. See *supra* Part II.A.

195. See *infra* Part IV.A–B.

196. See *infra* Part IV.A–B.

197. See *supra* Part II.C.

198. See *infra* Part IV.C.

199. See *infra* Part IV.D.

200. See *infra* Part IV.E.

A. *Structure and Text of § 6015*

When construing the actual knowledge exception to separation of liability relief under § 6015(c), the *Cheshire* and *Mitchell* courts relied in part on case law that interpreted the innocence requirement of § 6015(b) and former § 6013(e).²⁰¹ However, the courts' analogy is inapposite because there are several major differences between the knowledge provisions of innocent spouse relief and separation of liability relief. First, to qualify for innocent spouse relief under § 6015(b), an electing spouse has the burden of proving complete innocence—that is, the spouse must have no actual or constructive knowledge of the understatement.²⁰² In contrast, the knowledge provision under separation of liability relief is not a prerequisite requirement for the taxpayer to prove, but an exception that bars the provision's application and must be proved by the Service.²⁰³ This distinction, coupled with the remedial goals of § 6015,²⁰⁴ requires that courts read separation of liability relief liberally²⁰⁵ and the actual knowledge exception narrowly.

Second, the requirement of innocent spouse relief covers both a taxpayer's actual and constructive knowledge.²⁰⁶ In contrast, the knowledge exception to separation of liability relief only bars taxpayers who have actual knowledge of items giving rise to a deficiency.²⁰⁷ To incorporate the principle that ignorance of the law is not a defense from the case law interpreting former § 6013(e) is to charge taxpayers with a duty of inquiry about the legal consequences of omitting income, claiming a deduction, or credit.²⁰⁸ However, barring taxpayers with constructive knowledge from electing separation of liability relief contradicts the text, structure, and history of § 6015(c).²⁰⁹

201. See *Mitchell v. Comm'r*, 292 F.3d 800, 805 (D.C. Cir. 2002); *Cheshire v. Comm'r*, 282 F.3d 326, 336 (5th Cir. 2002); see also *supra* Part III.B.

202. See 26 U.S.C. § 6015(b)(1)(C) (2000); see also *supra* Part III; cf. *McCoy v. Comm'r*, 57 T.C. 732, 735 (1972) (noting that former § 6013(e) required “complete ignorance of the omission [of income]”) (alteration in original).

203. See 26 U.S.C. § 6015(c)(3)(C); *supra* notes 100–02 and accompanying text.

204. See *supra* notes 45–48 and accompanying text.

205. See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (“[W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes.”); accord *Peyton v. Rowe*, 391 U.S. 54, 65 (1968).

206. See 26 U.S.C. § 6015(b)(1)(C); see also *supra* Part III.

207. 26 U.S.C. § 6015(c)(3)(C).

208. See *Cheshire Amici Brief*, *supra* note 53, at 22.

209. *Id.*

Further, Congress specifically removed the concept of constructive knowledge from the actual knowledge exception of § 6015(c), noting that “[s]uch actual knowledge [that an item on a return is incorrect] must be established by the evidence and shall not be inferred based on indications that the electing spouse had a reason to know.”²¹⁰ The *Mitchell* court doubted that Congress would rely on a “subtle, ambiguous, obscure and imprecise device” like the actual knowledge exception to make ignorance of the law a defense.²¹¹ However, Congress emphasized in both the text of the statute²¹² and the accompanying legislative history²¹³ that only a showing of *actual* knowledge should bar separation of liability relief. By disallowing the Service’s use of *inferred* evidence²¹⁴ to prove a taxpayer’s actual knowledge, Congress eliminated the taxpayer’s duty of inquiry.²¹⁵ This restriction renders the principle that ignorance of the law is not a defense inapplicable to cases involving the separation of liability provision.²¹⁶ Thus, to give effect to this legislative intent, the principle that ignorance of the law is not a defense, developed in cases involving the innocence requirement of innocent spouse relief, should not be extended to the context of the actual knowledge exception to separation of liability relief.²¹⁷

Finally, the subject of a spouse’s knowledge is different under the two forms of relief: under innocent spouse relief, a taxpayer cannot have actual or constructive knowledge of an “understatement” of tax,²¹⁸ while under separation of liability relief, a taxpayer cannot have actual knowledge of an “item giving rise to a deficiency.”²¹⁹ In *Cheshire*, the Service argued that if Congress intended the knowledge exception to extend only to an “item on a return,” it could have referred instead to “an item of income that should have been reported on the return” or “actual

210. H.R. CONF. REP. NO. 105-599, at 253 (1998).

211. *See Mitchell v. Comm’r*, 292 F.3d 800, 805 (D.C. Cir. 2002).

212. *See* 26 U.S.C. § 6015(c)(3)(C).

213. *See* H.R. CONF. REP. NO. 105-599, at 253; *supra* text accompanying note 210.

214. *See* H.R. CONF. REP. NO. 105-599, at 253; *supra* text accompanying note 210.

215. *See Cheshire Amici Brief*, *supra* note 53, at 12; *see also supra* notes 188–89 and accompanying text.

216. *See Cheshire Amici Brief*, *supra* note 53, at 12–14.

217. *See id. Contra Mitchell v. Comm’r*, 292 F.3d 800, 805 (D.C. Cir. 2002); *Cheshire v. Comm’r*, 282 F.3d 326, 336 (5th Cir. 2002).

218. 26 U.S.C. § 6015(b)(1)(C) (2000).

219. *Id.* § 6015(c)(3)(C).

knowledge of the incorrect tax reporting of an item on a return.”²²⁰ Thus, the Service concluded that the item on a return meaning could not have been intended.²²¹ Congress, however, extended the actual knowledge exception to an “item giving rise to a deficiency,” a phrase that was unknown to the pre-1998 innocent spouse relief. Congress’ choice of new language implies its rejection of the line of cases interpreting the former innocent spouse provision. If Congress intended to incorporate the judicial knowledge of the transaction standard that was developed under the knowledge of an understatement requirement of former § 6013(e) and current § 6015(b), it probably would have referred to “the actual knowledge of an understatement” in § 6015(c).²²² But Congress did not do so, and chose instead to use new and different language in § 6015(c).

This new phrase chosen by Congress—“item giving rise to a deficiency”—is ambiguous.²²³ It can mean an income-producing transaction, as urged by the Service and adopted by the *Cheshire* and *Mitchell* courts.²²⁴ However, it can also mean an item on a joint return.²²⁵ The Code contains references to both of these potential readings.²²⁶ Because the meaning of the actual knowledge exception is ambiguous,²²⁷ the use of legislative history is appropriate to ascertain the meaning of this phrase.²²⁸

220. Brief for the Appellee, Commissioner of Internal Revenue at 36, *Cheshire v. Comm’r*, 282 F.3d 326 (5th Cir. 2002) (No. 00-60855) [hereinafter *Cheshire* IRS Brief].

221. *See id.*

222. The term *understatement* under § 6015(b) and former § 6013(e) covers cases of omitted income, erroneously claimed deduction or credit. *See supra* text accompanying notes 27–29 and Part III.A for discussion of courts’ interpretation of this term. Thus, Congress did not have to introduce the new term “item” to cover all cases that may cause a tax deficiency; it could have done so by preserving the terminology of innocent spouse relief.

223. *Cheshire v. Comm’r*, 115 T.C. 183, 202–03 (2000) (Colvin, J., dissenting). *Contra Cheshire v. Comm’r*, 282 F.3d 326, 337 (5th Cir. 2002).

224. *See Mitchell v. Comm’r*, 292 F.3d 800, 806 (D.C. Cir. 2002); *Cheshire*, 282 F.3d at 335, 337.

225. *See Cheshire*, 115 T.C. at 203 (Colvin, J., dissenting).

226. For example, 26 U.S.C. § 61(a) refers to “item” as an underlying transaction by providing that gross income includes various items listed in that section. In contrast, 26 U.S.C. § 57(a) refers to various “items of tax preference” defined by reference to tax consequences. *Cheshire*, 115 T.C. at 203 n.1 (Colvin, J., dissenting).

227. *Cheshire*, 115 T.C. at 202–03 (Colvin, J., dissenting). *Contra Cheshire*, 282 F.3d at 336–37 (concluding that the meaning of the statute is plain and declining to give any deference to the legislative history).

228. *See, e.g., Conn. Nat’l Bank v. Germain*, 503 U.S. 249, 255 n.1 (1992) (Stevens, J., concurring) (noting that “[w]hen there is some uncertainty about the meaning of a statute, it is

As the *Mitchell* court noted, the meaning of the term “item” is defined nowhere in the Internal Revenue Code and is unremarkably general.²²⁹ Because of the term’s potential breadth of meaning,²³⁰ courts should not analyze the word “item” in isolation and without reference to context.²³¹ Looking at the context and structure of § 6015, the phrase “item giving rise to a deficiency” and its variation, “item [that] gave rise to a tax benefit,”²³² are used exclusively in the context of separation of liability relief. There are four references to this phrase in § 6015, three of which appear in the rule for how to allocate items of income, deduction, and credit between spouses,²³³ and the fourth appears in the actual knowledge exception.²³⁴ The text of the allocation rules implies that “an amount on a return can be allocated, i.e., split” between spouses, while “an underlying transaction or activity cannot,” which supports the item on a return interpretation.²³⁵ Under the rules of statutory construction, identical words or phrases used in different parts of the same act are intended to have the same meaning, especially where the word or phrase is repeatedly used in the act.²³⁶ This principle supports interpreting the

prudent to examine its legislative history” and quoting Judge Learned Hand’s advice in *Lehigh Valley Coal Co. v. Yensavage*, 218 F. 547, 553 (2d Cir. 1914), that statutes “‘should be construed, not as theorems of Euclid, but with some imagination of the purposes which lie behind them’”; *United States v. Pub. Utils. Comm’n of Cal.*, 345 U.S. 295, 315 (1953) (“Where the language and purpose of the questioned statute is clear, courts, of course, follow the legislative direction in interpretation. Where the words are ambiguous, the judiciary may properly use the legislative history to reach a conclusion.”); *Cheshire*, 115 T.C. at 204 (Colvin, J., dissenting).

229. See *Mitchell*, 292 F.3d at 805.

230. The word “item” is used in the Code more than two thousand times, including fifteen times in § 6015(c). See *Cheshire v. Comm’r*, 282 F.3d 326, 335 (5th Cir. 2002).

231. See, e.g., *Owasso Indep. Sch. Dist. v. Falvo*, 534 U.S. 426, 434 (2002) (stating that “[i]t is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme”) (internal citations omitted); *Deal v. United States*, 508 U.S. 129, 132 (1993) (noting that a “fundamental principle of statutory construction (and, indeed, of language itself) [is] that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used”).

232. See 26 U.S.C. § 6015(d)(3)(B) (2000); see also *supra* note 92.

233. The three references are: (1) the subheading of the allocation rule, “Allocation of Items Giving Rise to the Deficiency,” 26 U.S.C. § 6015(d)(3); (2) the mechanics of allocation, see 26 U.S.C. § 6015(d)(3)(A); *supra* note 89; and (3) the tax benefit exception to the usual operation of the allocation rule, see 26 U.S.C. § 6015(d)(3)(B); *supra* note 92.

234. See 26 U.S.C. § 6015(c)(3)(C).

235. *Cheshire v. Comm’r*, 115 T.C. 183, 206 (2000) (Colvin, J., dissenting).

236. See, e.g., *Cohen v. de la Cruz*, 523 U.S. 213, 220 (1998) (noting the presumption that “equivalent words have equivalent meaning when repeated in the same statute”); *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 570 (1995) (restating the “normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning”).

term “item” giving rise to a deficiency or tax benefit consistently throughout the separation of liability relief provision.

B. Legislative History of the Actual Knowledge Exception

The structural and textual analysis of the phrase “item giving rise to a deficiency” is supported by the history of § 6015’s adoption. The legislative history demonstrates that Congress enacted the actual knowledge exception to prevent taxpayers who knowingly sign false returns from abusing separation of liability relief. In accordance with this purpose, Congress limited the scope of the taxpayer’s knowledge to the knowledge of an error on a return.

1. Purpose of the Actual Knowledge Exception

The legislative history of separation of liability relief begins with the Senate report,²³⁷ in which the actual knowledge exception was listed among the three “special rules” that were adopted “to prevent the inappropriate use of the election.”²³⁸ The Senate Committee stated that it created these special rules to prevent taxpayers from abusing separation of liability relief by knowingly signing false returns and by transferring assets to avoid the payment of tax.²³⁹ Two special rules address only asset transfers in fraudulent and tax avoidance schemes.²⁴⁰ The third special rule is the actual knowledge exception.²⁴¹ When the Senate Committee, Senator D’Amato, and the Staff of the Joint Committee on Taxation stated that taxpayers should not be allowed to abuse these rules “by knowingly signing false returns, or by transferring assets for the purpose of avoiding the payment of tax,”²⁴² the reference to “knowingly signing false returns” must refer to the actual knowledge exception because it is the only special rule left that does not involve asset transfers. Thus, the legislative history shows that the intended purpose of

237. See S. REP. NO. 105-174, at 55–60 (1998); see also *supra* notes 52–62 and accompanying text.

238. S. REP. NO. 105-174, at 59; see also H.R. CONF. REP. NO. 105-599, at 253–54 (1998); *supra* text accompanying notes 95–101.

239. S. REP. NO. 105-174, at 55–56, 59; see *supra* text accompanying note 136.

240. See 26 U.S.C. § 6015(c)(3)(A)(ii), (c)(4) (2000); see also *supra* text accompanying notes 98–99.

241. See 26 U.S.C. § 6015(c)(3)(C). See also *supra* note 102 for statutory text.

242. S. REP. NO. 105-174, at 55–56; GENERAL EXPLANATION, *supra* note 81, at 67; accord 144 CONG. REC. S4474 (daily ed. May 7, 1998) (statement of Sen. D’Amato).

the actual knowledge exception was to prevent taxpayers who knowingly sign false returns from taking advantage of § 6015(c) relief.

Confronted with this same legislative history suggesting the item on a return meaning, the Service argued that this interpretation would render the actual knowledge exception superfluous.²⁴³ The Service asserted that this interpretation makes the actual knowledge exception unnecessary in light of the fraud provision which authorizes the Secretary to reallocate items if there is fraud by one or both spouses.²⁴⁴ However, the Service's objection is without merit for the following reasons.

The actual knowledge exception targets the taxpayer's ability to elect § 6015(c) relief in general, unlike the fraud provision that only limits the application of allocation rules. There are five limitations on separation of liability relief. Two of them limit the allocation of items to spouses that otherwise qualify for § 6015(c) relief, including the fraud provision on which the Service relied.²⁴⁵ In contrast, the other three special rules, including the actual knowledge exception, limit the claimant's ability to elect separation of liability relief in general.²⁴⁶ Furthermore, the fraud restriction allows the Secretary to reallocate items in his or her discretion whereas the actual knowledge exception is a non-discretionary provision that automatically bars § 6015(c) relief for a deficiency attributable to items that a spouse knew were reported incorrectly.²⁴⁷ Because the fraud restriction provides for discretionary reallocation of items, while the actual knowledge exception bars relief outright upon the Secretary's proof that a claimant spouse knew about errors on a return when he or she signed it, the application of these two provisions is distinctly different, and the item on a return interpretation will not render the actual knowledge exception superfluous. Therefore, the purpose of the actual knowledge exception, derived from the provision's legislative

243. See *June 2001 IRS Hearing*, *supra* note 155, ¶¶ 102, 107 (remarks of Judy Wall, Branch Chief, IRS Procedure and Administration); *supra* note 156 and accompanying text.

244. See *June 2001 IRS Hearing*, *supra* note 155, ¶¶ 102, 107 (remarks of Judy Wall, Branch Chief, IRS Procedure and Administration); *supra* note 156 and accompanying text; see also 26 U.S.C. § 6015(d)(3)(C); *supra* note 89.

245. See 26 U.S.C. § 6015(d)(3)(C); *supra* note 89. The other allocation limitation is the tax benefit provision. See 26 U.S.C. § 6015(d)(3)(B). See also *supra* note 92 for statutory text.

246. See H.R. CONF. REP. NO. 105-599, at 253-54 (1998); S. REP. NO. 105-174, at 59; see also *supra* note 238 and accompanying text. The first two limitations are placed in 26 U.S.C. § 6015(d), which covers "[a]llocation of deficiency," whereas the other three limitations are in 26 U.S.C. § 6015(c), which covers "[p]rocedures to limit liability for taxpayers no longer married or taxpayers legally separated or not living together."

247. See 26 U.S.C. § 6015(d)(3)(C), (c)(3)(C).

history, can be effectuated only by giving the exception its intended item on a return meaning.

2. *Scope of the Actual Knowledge Exception*

The scope of the actual knowledge exception must be interpreted in light of the legislative intent to prevent abuse of § 6015(c) relief by spouses who knowingly sign false returns. Introducing the floor amendments to the actual knowledge exception,²⁴⁸ Senator Graham referred to its scope as actual knowledge of “the conditions within that return which led to this deficiency,”²⁴⁹ the joint return’s contents,²⁵⁰ and “the circumstances in the return that led to the deficiency.”²⁵¹ The Senate report explained that the Service would be required to prove “that the electing spouse had actual knowledge that an item on a return is incorrect.”²⁵² The Conference Committee report,²⁵³ the Joint Committee General Explanation of the 1998 Tax Legislation,²⁵⁴ and another Joint Committee document prepared three years after the statutory enactment²⁵⁵ are all in accord with the Senate report.

While the Fifth Circuit in *Cheshire* rejected § 6015(c)’s legislative history as ambiguous and inconclusive,²⁵⁶ the *Cheshire* Tax Court majority noted the contradiction between its holding and the legislative history.²⁵⁷ The majority resolved the conflict by treating the legislative history as only an example.²⁵⁸ However, as Judge Colvin noted in his dissent, Congress’ statements describing the scope of the actual

248. See 144 CONG. REC. S4473–74 (daily ed. May 7, 1998); *supra* note 57.

249. 144 CONG. REC. S4474; see also *supra* text accompanying note 140.

250. 144 CONG. REC. S4474. Although this statement was made in conjunction with the duress portion of the actual knowledge exception amendments, the scope of the exception is the same whether it is applied to a taxpayer under duress or not.

251. *Id.*

252. S. REP. NO. 105-174, at 59 (1998); see also *supra* note 135 and accompanying text.

253. H.R. CONF. REP. NO. 105-599, at 253 (1998).

254. GENERAL EXPLANATION, *supra* note 81, at 70.

255. JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT LAW RELATING TO THE INNOCENT SPOUSE, OFFERS-IN-COMPROMISE, INSTALLMENT AGREEMENT, AND TAXPAYER ADVOCATE PROVISIONS OF THE INTERNAL REVENUE CODE, JCX-22-01, at 3 (J. Comm. Print 2001).

256. *Cheshire v. Comm’r*, 282 F.3d 326, 337 (5th Cir. 2002); cf. *Mitchell v. Comm’r*, 292 F.3d 800, 804–06 (D.C. Cir. 2002) (no discussion of legislative history or intent).

257. *Cheshire v. Comm’r*, 115 T.C. 183, 195 (2000) (“Arguably, this statement [that the IRS must prove that “the electing spouse had actual knowledge that an item on a return is incorrect”] conflicts with our knowledge standard for purposes of section 6015(c)(3)(C).”).

258. *Id.*

knowledge exception are explanations of the general rule, not examples, because Committees have a specific way of introducing examples by using the preceding phrase “for example.”²⁵⁹ Indeed, the Conference Committee report contains an actual example in the paragraph immediately following this explanation of the statutory rule.²⁶⁰

The allegedly inconsistent self-employment income example²⁶¹ can be reconciled with the legislative intent Congress expressed elsewhere. First, the example’s purpose was to demonstrate how a tax deficiency is *allocated* between spouses when one spouse knows of a *portion* of the other spouse’s omitted income. The example does not address the *scope* of the spouse’s knowledge.²⁶² The Senate report, where the example originated, placed it in a section titled “[t]ax deficiencies,”²⁶³ explaining how the § 6015(d) allocation rules function. During the conference, the example was moved to the “special rules” discussion²⁶⁴ immediately following the explanation of the actual knowledge provision’s scope.²⁶⁵ These structural changes should not distort the example’s main purpose: to demonstrate the allocation of a tax deficiency if a claimant knows of some, but not all, of the other spouse’s items giving rise to a deficiency.

Second, the use of self-employment income in the example creates a presumption that if the wife knows about her husband’s self-employment income, she necessarily knows it is taxable. Therefore, she should also know that the omission of self-employment income from the return is incorrect. The Service has responded to this argument by attempting to stretch the example to cover a *self-employment tax* deficiency as well as an *income tax* deficiency.²⁶⁶ The Service’s reading of the legislative history has no textual support, given that there is no indication that Congress intended the example to illustrate anything other than the allocation rules when one spouse has actual knowledge

259. *Id.* at 206 n.3 (Colvin, J., dissenting).

260. H.R. CONF. REP. NO. 105-599, at 253 (1998).

261. *See supra* notes 121–23 and accompanying text.

262. *See Cheshire*, 115 T.C. at 206 (Colvin, J., dissenting).

263. S. REP. NO. 105-174, at 57–58 (1998).

264. H.R. CONF. REP. NO. 105-599, at 253; *see also supra* text accompanying notes 95–101.

265. H.R. CONF. REP. NO. 105-599, at 253.

266. *See* Summary of Comments and Explanation of Revisions, 67 Fed. Reg. 47,278, 47,282 (July 18, 2002); *June 2001 IRS Hearing*, *supra* note 155, ¶¶ 108, 111–12 (remarks of Bridget Finkenaar, Attorney-Advisor, IRS Procedure and Administration); *see also supra* text accompanying notes 158–60.

about a portion of the item.²⁶⁷ This dislocated example should not overcome the strong evidence that Congress intended the actual knowledge exception to cover only cases where taxpayers actually know that they have signed a return that contains an incorrect item. Thus, the scope of the actual knowledge exception should be interpreted consistently with the legislative history of § 6015(c) to mean actual knowledge that an item on a return is incorrect.

C. *Treasury Regulations*

The Regulations provide three distinct tests under § 6015(c) for cases that involve an omission of income, erroneous deduction, and fictitious or inflated deduction or credit.²⁶⁸ However, Congress established only one standard: whether a taxpayer has “actual knowledge . . . of an[] item giving rise to a deficiency.”²⁶⁹ This standard is distinct from the prerequisite of complete innocence, which taxpayers must prove to qualify for relief under § 6015(b).²⁷⁰ The Treasury improperly split Congress’ single standard into three tests that roughly parallel the case law interpreting former § 6013(e).²⁷¹ This division is artificial and is not based on the structure, text or legislative history of § 6015(c).²⁷² When Congress intends to treat income, deduction, or credit separately, it does so.²⁷³ The more accurate reading of the knowledge exception is that it is one standard that applies equally to all types of cases: it bars relief to a taxpayer who, at the time of signing the return, has actual knowledge that the “item” listed on a return—be it omitted income, an improperly claimed deduction or credit—gave rise to a deficiency on a return.

D. *Policy Considerations*

First and foremost, separation of liability relief must be interpreted liberally in light of its broad remedial purpose.²⁷⁴ Courts should

267. See H.R. CONF. REP. NO. 105-599, at 253; S. REP. NO. 105-174, at 58.

268. See *supra* Part II.C.

269. 26 U.S.C. § 6015(c)(3)(C) (2000).

270. *Id.* § 6015(b)(1)(C); see also *supra* Part III.

271. See *supra* Part III.

272. See *supra* Part IV.A–B.

273. See, e.g., 26 U.S.C. § 6015(d)(2) (distinguishing allocation of disallowed credit from the general allocation principles); see also H.R. CONF. REP. NO. 105-599, at 252–53 (1998); S. REP. NO. 105-174, at 57–59 (1998).

274. See *supra* notes 45–48, 205 and accompanying text.

recognize Congress' intent behind § 6015(c)—to provide a different, mechanical-like relief²⁷⁵ to divorced or separated taxpayers, free from the fact-dependent inquiry of the innocence and equity requirements of § 6015(b) relief.²⁷⁶ Applying case law interpreting § 6015(b) innocent spouse relief to the new separation of liability provision undermines Congress' intent to create a new and different remedy from prior innocent spouse law.²⁷⁷

The Service successfully argued to the *Cheshire* Tax Court majority that the item on a return interpretation would render the actual knowledge exception meaningless because potentially any spouse who is not a certified public accountant or tax attorney would be allowed to escape paying income tax.²⁷⁸ Yet, this argument should be rejected as having no merit because separation of liability relief was created to allow divorced or separated taxpayers to separate responsibilities for only their individual share of a tax deficiency.²⁷⁹ If one spouse obtains separation of liability relief, the Service is not left without a taxpayer from whom it can collect tax deficiencies. Instead, the Service can collect from the other spouse, whose income, deduction or credit actually produced the deficiency. The *McCoy* court's fear that potentially both spouses could be found innocent, leaving the Service without a taxpayer to collect from²⁸⁰ is thus unfounded.

E. Proposed Amendment

Congress should amend § 6015(c) to clarify the meaning of the actual knowledge exception. Instead of its current ambiguous phrasing,²⁸¹ the statute should read: "If the Secretary demonstrates that an individual making an election under this subsection had actual knowledge that an item of income, deduction or credit is incorrectly reported on a return, the election will not apply to the extent any deficiency is attributable to

275. See 2000 NATIONAL TAXPAYER ADVOCATE'S ANNUAL REPORT TO CONGRESS, *supra* note 161, at 91.

276. See *Cheshire Amici Brief*, *supra* note 53, at 14; *supra* text accompanying notes 36–42.

277. See *Cheshire Amici Brief*, *supra* note 53, at 18.

278. *Cheshire v. Comm'r*, 115 T.C. 183, 197 (2000); *Cheshire IRS Brief*, *supra* note 220, at 41.

279. See H.R. CONF. REP. NO. 105-599, at 252 (1998).

280. *McCoy v. Comm'r*, 57 T.C. 732, 735 (1972); *Borison*, *supra* note 117, at 834.

281. See *supra* note 102 for statutory text of 26 U.S.C. § 6015(c)(3)(C) (2000).

such item.”²⁸² Alternatively, the Treasury could amend its Regulations using similar language, thereby giving proper effect to Congress’ intent behind the actual knowledge exception.

V. CONCLUSION

The application of the innocent spouse relief provision has been heavily litigated since its inception in 1971. In 1998, Congress intended to expand the available relief to a greater number of taxpayers. However, courts have interpreted the new remedies narrowly. By expanding the scope of the actual knowledge exception, courts have barred many taxpayers from obtaining separation of liability relief. Congress should clarify its intent by amending the actual knowledge exception to give separation of liability its intended reach. Alternatively, the Treasury should amend its Regulations to bring them in line with the legislative intent, as evidenced by § 6015(c)’s history, structure, and text. The bonds of joint tax liability should not be stronger than marriage.

282. *Cf.* H.R. CONF. REP. NO. 105-599, at 253; S. REP. NO. 105-174, at 59 (1998) (stating that the Service is required to prove that “the electing spouse had actual knowledge that an item on a return is incorrect”).

